

**HONDURAS MICRO AND SMALL
ENTERPRISE DEVELOPMENT:**
***“WORKING PAPER ON THE EVOLUTION OF THE
SECTOR AND USAID’s ASSISTANCE”***

Prepared By: Bernai Velarde, Small Business Advisor



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ANALYZE THE IMPACT OF DEVELOPMENT ASSISTANCE IN HONDURAS.***

1. HONDURAN BACKGROUND

Honduras with a population of 5.4 million and an area of 112, 000 square kilometers is the fourth poorest country in Latin America. With a GDP of only \$673 per capita, only Haiti, Guyana and Nicaragua are lower.¹ More than two-thirds of Hondurans, an estimated 3.5 million people, live below the poverty line. Honduras has a large number of poor people in both urban and rural areas. About 36% of Honduran families receive less than \$50 a month and 62% receive less than \$100. The UNDP reports that 47% of Hondurans live in absolute poverty, not earning enough for an adequate diet.

The principal economic and social problems facing Honduras are high rates of poverty and unemployment. The contrast between poverty and wealth in Honduras is among the most extreme in the region. The highest 10% of the population receives 48% of the national income and the lower 20% of the population receives less than 2.7% of the national income.² The policies pursued by Honduras during the early 1980's was one of protectionism, price ceilings, high fiscal expenditures, increasingly financing the deficits with borrowed money and by printing money. The Honduran scenario was aggravated by the fact that the region was facing civil war in most of Central America (Nicaragua, El Salvador and Guatemala). This contributed to undermine investors' confidence and provoked capital flight from the country.

2. THE ROLE OF MICROENTEPRISE

A number of studies, suggest that the efficient substitution of labor for capital is possible in a broad spectrum of activities. Small and Micro Enterprises (SMEs) tend to be more labor-intensive than larger businesses and tend to generate more direct and probably more indirect jobs per unit of invested capital on the average.³ SMEs provide a seedbed for entrepreneurial talent, supplying dynamism and competition in the economy and generally raising the level of the poor's participation in the economy. Starting in the early 1980's USAID supported SMEs as part of a strategy for promoting both economic growth and more equitable development.

3. MARKET SIZE

The World Bank and the Central Bank of Honduras estimated that in 1984, the informal sector provided approximately one-half of the total off-farm employment and contributed about 10% of the Gross Domestic Product of the country. These organizations estimated that approximately 300,000 individuals were employed by

¹ USAID Results Review and Resource Request, February 1996.

² The World Development Report Tables, The World Bank, 1994.

³ Employment and Development of Small Enterprises, Sector Policy Paper, World Bank, February 1978.

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about 78,000 micro and small enterprises. In addition, there were about 40,000 microbusiness market vendors and street merchants that employ an additional 120,000 persons.

A 1994 household survey conducted by the Government of Honduras indicates that the economically active population (EAP) in Honduras is about 1.8 million persons of which 1.1 million persons work in the informal sector. See the table below.

ECONOMICALLY ACTIVE POPULATION OF HONDURAS (EAP)⁴
(000s⁵)

DESCRIPTION	NATIONAL	RURAL	%	URBAN	%
Economically Active Population	1,825	993	54	832	46
Formal Sector EAP	710	245	35	465	65
Firms with 10 or more employees	404	139	34	265	66
Public Employees	137	47	34	90	66
Domestic Service	65	22	34	43	66
Various	105	38	36	67	64
Informal Sector EAP	1,115	748	67	367	33
Self-employed	400	259	65	141	35
Firms with 1 to 4 employees	586	416	71	170	29
Firms with 5 to 9 employees	129	74	57	56	43

Source: Chart No. 21, XII Household Survey, DGCE, Published July 1995

4. CHARACTERISTICS OF MICROENTERPRISES

Microenterprises are typically informally organized businesses owned and managed by people broadly categorized as the working poor. These persons have very low incomes, little education, and limited or no access to commercial credit. Most of the businesses are family-owned and operated and are often headed by women. The vast majority of the businesses generally have less than 10 employees. Microenterprises tend to be more labor intensive than the larger businesses and generally raise the level of the poor's participation in the economy.

⁴ Informal sector in this chart includes self-employed persons, and firms with nine or less employees, including the agriculture sector which employs 673,782 persons. If we exclude the agriculture sector we find that 1 of every 4 persons in Honduras are occupied by the informal sector.

⁵ Total numbers may not add due to rounding to the nearest 1,000.

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5. GOALS AND OBJECTIVES OF THE USAID PROGRAM, THE 1980's

The specific strategy supported by the Mission during the early 1980's intended to:

- Build the capacity of existing local institutions or encourage non-specialized institutions to begin new SME programs by providing financial and technical assistance.
- Strengthen existing SMEs in the growth corridor between Tegucigalpa and San Pedro Sula by providing research and marketing assistance.
- Create new SMEs by providing access to financial resources.

6. ISSUES

One of the main priorities of the government was to attack poverty and create investment and employment opportunities. Microenterprise activities were seen as one of the tools that could furnish opportunities to the poor. Microenterprise in itself and other economic activities could not thrive if macroeconomic stability was not achieved. In the late 1980s the Honduran government took the decision to take corrective actions and embarked on a structural adjustment program.

Some of the policies that affected the environment to support adequate microenterprise programs are synthesized below.

**A SUMMARY OF THE MAJOR MACROECONOMIC HONDURAN
POLICIES THAT AFFECTED MICRO AND SMALL BUSINESS**

ISSUES AND CURRENT STATUS
A 17% interest rate ceiling was in place. The interest rate ceiling created financial repression against small borrowers, favoring the larger firms and making it next to impossible to have self-sufficient micro-finance intermediaries. At the end of 1990 the government decided to eliminate the interest rate ceiling.
The GOH had a fixed exchange rate policy of L2:\$1. Only well connected larger firms had access to this exchange rate. Currently the government has instituted an open market auction system for dollars, thus leveling the playing field. In addition the GOH is committed to further increase the flexibility of the system to meet its balance of payment program. ⁶
Trade policies (high tariffs) protected the large firms not the small firms. A reduction in tariff was agreed upon and implemented by the GOH.

⁶ Honduras, Midterm Review under the Second Annual ESAF Arrangement, International Monetary Fund, November 28, 1995.

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ISSUES AND CURRENT STATUS
<p>High Reserve Requirements for the Banking System: The government agreed to reduce the reserve requirement over a period of three years. However, in July 1995 the Central Bank had to suspend the gradual reduction of the reserve requirements to keep the credit expansion within the targeted level agreed with the IMF.⁷ The IMF and the GOH however, have agreed to resume a gradual reduction of the reserve requirement as inflation is brought under control.</p>
<p>Government credit programs for small businesses were plagued by serious losses. The programs had no impact and no possibility of becoming self-sustaining. The Industrial Development Center (Spanish Acronym: CDI) for example gave 956 loans from 1979 to 1986 and most of the portfolio was never recovered. The special small business credit programs managed by the GOH were closed down.</p>
<p>PVOs with a social vision started to become involved in microenterprise development. The vast majority of these PVOs charged subsidized interest rates, had a high percentage of loans in arrears and no possibility of becoming self-sustaining. Today a small group of PVOs has emerged with a vision that requires them to be viable financial intermediaries in order to provide financial services.</p>
<p>Institutional Development Constraints of the PVOs: Limited accounting systems, no manuals on administrative and financial procedures. Institutions did not have strategic plans, no computer systems were in place, the loan approval process and monitoring and collection systems were inadequate. The PVOs that have evolved into specialized microfinance institutions have adequate systems and procedures in place.</p>
<p>Savings: Savings were not seen as an important financial service demanded by the informal sector. Today a selected group of PVOs have recognized that there is a large and unmet demand for savings services. This small group of PVOs plans to create formal financial intermediaries that will be able to mobilize local resources to finance the expansion of their loan programs.</p>
<p>Contradictory Donor Policies: Most of the donor community, excluding USAID was promoting subsidized interest rate to the ultimate borrower. Most programs financed by international donor had interest rate ceilings in place. Today with one exception all donors promote market rates.</p>

During the 1980's microenterprise programs had no possibility of becoming self-sustaining. The interest rates charged by the PVO community were below the bank rates. In general terms it was more expensive to make a loan than to give the money out directly to the micro business; i.e., it would cost more than one dollar to make a dollar loan. Attempts were made to introduce new loan methodologies such as the solidarity lending methodology but the efforts failed. The vision and focus of the PVO community were social in nature. The organizations believed that the poor could not pay market rates and resisted the advice to charge these rates. The PVOs were not interested in capitalizing their organizations and expected to continue to receive subsidies for their programs from international donors. The largest PVOs would not make more than 500 loans a year. The PVO community did not have any significant impact at a national scale. The vast majority of PVOs had portfolios with 50 to 250 loans. The people who accessed these programs were seen as beneficiaries and not as customers. The Government of Honduras was involved in direct lending to small business as well as through a second tier lending mechanism through commercial banks without any success, e.g.; the National Industrial Development

⁷ Ibid Footnote No. 6

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Fund (FONDEI) was making about 200 loans a year to medium size businesses, while the CDI made 956 loans in eight years. The loan techniques had not been perfected. All the institutions had high operational costs and extremely high (over 40%) percentages of loans in arrears.

7. *ACTIVITIES SUPPORTED BY USAID/HONDURAS IN THE 1980'S*⁸

During the early and middle 1980's the Mission supported the following discrete project activities:

- **Pan American Development Foundation** (Project No. 522-0263) for a total amount of \$132,000. This grant was given to the Pan-American Development Foundation to assist the Chamber of Commerce of Cortes to organize and create a PVO (National Foundation for the Development of Honduras - FUNADEH) that would provide credit and technical assistance services to small businesses in the northern coast region of Honduras.
- **Small Scale Enterprise Assistance** (Project No. 522-ESF-0263) to complement the efforts of the Pan American Development Foundation, an additional equivalent amount of \$1,000,000 from local currency was programmed to help the local PVO FUNADEH, establish a credit program for small businesses. At the end of the Project, FUNADEH had made 773 loans for a total amount of approximately \$10.0 million.
- **Federation of Private Development Organizations -FOPRIDEH-** (Project No. 522-0266) for a total amount of \$500,000. This grant financed short and long term technical assistance to provide institutional strengthening to the Federation of PVOs and that of its affiliates.
- **Artisan Product Marketing** (Project No. 522-0250) for a total amount of \$510,000. This grant was given to a US PVO (AID to Artisan) that supported the development of new artisan products that were subsequently exported to the US. It created employment for approximately 280 people of whom the majority were rural women working with vegetable fibers.
- **Small Business Development** (Project No. 522-0205) for a total amount of

⁸ The micro and small enterprise activities supported by USAID were financed from development assistance resources (DA) and from local currency (LC) that was generated from the economic support funds (ESF) that USAID provided to the Government of Honduras

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\$800,000 (Grant) and the equivalent amount of \$4,000,000 from local currency. The purpose of this project was to develop a source of accessible financial and technical assistance for Honduran small and medium scale entrepreneurs. The project assisted in the creation of a finance company that was capitalized by five local commercial banks. This institution provided credit services, made equity investments, cofinanced loans with its shareholder banks, and gave financial advice to its clients. At the end of this four year project, the finance company had made about 100 loans for an approximate amount of \$4.0 million. In addition, this Project financed the creation of a second tier program managed by the National Association of Honduras that supported institutions that showed the interest and capability of providing services need by small businesses.

- **Microenterprise Development Program** (Project No. 522-ESF-0319) for a total equivalent amount of \$325,000 from local currency. This grant was given to a US PVO (Accion International) to provide assistance to a local PVO in establishing a credit and technical assistance program for microenterprises. New loan methodologies (*group lending*) were introduced for the small enterprises in four urban centers. During the life of the project, Accion International assisted the local PVO in disbursing 5,053 loans for a total amount of \$1.8 million.

The total estimated amount of resources utilized during the first phase of micro and small business development in Honduras is approximately \$7,267,00 distributed as follows:

Development Assistance: \$1,942,000
Local Currency Funds: \$5,325,000.

8. LESSONS LEARNED

- Discrete activities are important, but an adequate economic policy and regulatory environment are needed so that SMEs may prosper.
- In general, the government should not be involved in direct lending to customers. Most of the programs (with few exceptions) are poorly managed and need massive subsidies to continue operation.
- Programs need to respond to market realities. The products offered to the informal sector should respond to the clients' preferences and meet their needs.
- Savings are an important service demanded by the informal sector. Savings facilities are also a key element to finance the expansion of the loan programs of the financial intermediaries serving the poor.

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- Self-sufficiency is a requirement of the programs; they should not be seen as a wish but as a prerequisite for offering financial services.
- The latest microfinance techniques should be used to ensure the feasibility of the program. These include short term working capital; group collateral to motivate repayment; repeat loans of a larger size for those who pay on time and need additional resources; minimum productivity requirements; simplified and decentralized loan processes; market rates; office standardization or franchise; and savings services and instruments.
- A goal of microenterprise development is the transformation of successful institutions into formal financial sector intermediaries so they may provide full financial services to the informal sector.

9. *USAID's CURRENT SME PROGRAM*

During the late 80's and early 90's the GOH undertook a structural adjustment process. During this period the Mission undertook a series of studies to measure the impact that the adjustment process had on SMEs. The last survey undertaken in 1992⁹ indicated that the number of jobs in, or among the SME Sector was reduced by 2% between 1989 and 1990 but by mid 1992 it had fully recovered. The payrolls of SMEs were reduced by 18% in real terms during the adjustment period but by 1992 they had increased (from the base period) by 28%. The sales of SMEs maintained the same pattern. In 1990 sales of SMEs were reduced on average by 6% in real terms but by 1992 they had increased by 23%. This clearly demonstrates the ability of microenterprise to rapidly adjust to the changing macroeconomic environment and to flourish with the right policies.

The structural adjustment process also made it possible to have sustainable microenterprise assistance programs for the first time. The interest rate ceiling was eliminated, thus giving intermediaries a real opportunity to become viable financial intermediaries.

During this period the Mission re-focused its micro and small business assistance strategy to support institutions committed to becoming self-sustaining during a reasonable short period of time. The numbers of institutions assisted by the USAID financed project dropped from approximately 30 to 7. **The focus of the program today is to help microfinance intermediaries provide financial services to a significant number of clients at a national level on a sustainable basis.** USAID's assistance encourages a higher degree of competition and improved financial services

⁹ Evolucion de la Pequeña y Microempresa en Honduras: 1989 a 1992, Nathan & Associates, Inc.

for the poor.

The existing Small Business II Project assists microfinance institutions to: (1) reach a greater number of clients; (2) continue its focus on women and the very poor; (3) support the institutional efforts to achieve sustainability and financial self-sufficiency and; (4) assist a successful PVO to transform itself into a licensed commercial bank to mobilize deposits from the public and lend the resources to micro and small enterprises. Best microfinance practices are being introduced to support the efforts of the PVOs to become specialized microfinance institutions so they will be in the position to tap commercial sources of funds.

10. ACTIVITIES SUPPORTED BY USAID/HONDURAS IN THE 1990'S¹⁰

During the late 80's and 90's USAID financed the following discrete activities through the Small Business II Project:

- **Bilateral Agreement** (Project No. 522-0241) for a total amount of \$16.0 million financed by local currency and \$2.2 million from development assistance. The project financed the creation of a second tier lending and guarantee facility, to provide liquidity and security to private commercial banks and financial institutions that made loan to small scale enterprises. By the end of the five year project activity, the second tier facility made over 5,000 loans for nearly \$83.0 million. In addition it had guaranteed over 1,500 loans for a value of nearly \$18.0 million. The program generated approximately 10,400 direct jobs during this period. This activity was crucial element in the policy dialogue with the Government of Honduras that eventually led to the elimination the interest rate ceilings imposed by the Central Bank.
- **Contract with Nathan & Associates, Inc.**, (Contract No. 522-0241-C-00-8452, which expired in September 1995) for an estimated amount of \$5.8 million. The overall objective of this contract was to provide short and long-term assistance to all the participating institutions under the Small Business II Project. Technical assistance was given in the following areas: credit, marketing, program management and administration, management information systems, policy analysis and research and financial management. This contract was essential in order to modernize and institutionalize the financial functions of selected PVOs that continued to receive assistance from USAID. Through this institutional contract USAID persuaded the PVO community and the donor community to adopt market interest rates and policies for the microenterprise programs. For example, in the

¹⁰ Ibid Footnote 8.

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late 1980's the IDB Office in Honduras had an interest rate ceiling policy for all activities financed by its Small Projects program. Through various USAID/IDB meetings a market credit policy was adopted by the IDB and joint coordination meetings were held to discuss collaboration and assistance to the micro and small business sector.

- **Grant Agreement with Asesores para el Desarrollo** (Project No. 522-0241.02) for an estimated amount of \$2.0 million. The purpose of this project was to strengthen and expand ASEPADE's microenterprise support program. The Grant Agreement was terminated due to the inability of the intermediary (ASEPADE) to adequately manage its loan portfolio. Only \$ 892,000 was disbursed for this activity. During the project implementation ASEPADE disbursed over 10,000 loans. When the project was closed ASEPADE had nearly 3,00 clients with an outstanding loan portfolio of L3.8 million in 1992.

Currently, USAID/Honduras has two active projects:¹¹

- **Cooperative Agreement with ANDI/Covelo** (Project No. 522-0241.01) for a total amount of \$6.0 million. The purpose of this agreement is to help build a sustainable financial intermediation system that will provide financial services to microenterprise at a national level. Covelo is currently working with five PVOs and is assisting them to become financially self-sustaining by the end of 1998. Covelo is providing technical and financial assistance so that these PVOs may accelerate their market penetration and increase their scale of operations. In addition, Covelo has established a microfinance demonstration program that introduces best practices in Honduras.
- **Cooperative Agreement with FUNADEH** (Project No. 522-0241.02) for a total amount of \$4.1 million. The objective of this Cooperative Agreement is to assist FUNADEH to: (1) help design and create a viable for profit commercial bank that will provide full financial services to micro and small businesses in Honduras and; (2) support pilot projects that will introduce new techniques to increase FUNADEH's financial outreach and penetration in the microenterprise community.

The total estimated amount of resources utilized during the second phase of micro and small business development in Honduras is approximately \$35,000,000 distributed as follows:

Development Assistance: \$19,025,000

¹¹ The results of the active project components are listed in section 11.

Local Currency Funds: \$16,000,000.

11. MAJOR RESULTS OF ACTIVE PROJECTS BY DECEMBER 1995

As a result of the changes introduced in the business environment due to the structural adjustment process and the change in the Mission's strategy for microenterprise development, the following results were achieved by the end of 1995:

- The vision and mission of the assisted organizations have changed from that of a social organization requiring grants to subsist, to that of a specialized microfinance organization which must be financially sustainable in order to provide financial services.
- The number of active clients served by 5 PVOs at the end of the year was 20,344. This compares to probably less than 3,000 active clients by 30 PVOs in 1985.
- Ninety-two percent of the active clients are poor women.
- The PVO network disbursed about 43,000 loans during 1995.
- There are 745 village banks throughout Honduras providing loans and savings services to primarily poor women.
- Approximately 80% of all loans are of a value of less than \$300.
- All PVOs charge market interest rates at a level well above those generally charged by commercial banks.
- All PVOs have strategic plans in place with benchmarks that lead toward financial sustainability.
- One PVO has started to reorganize to provide full financial services by creating a commercial bank to mobilize funds from the public at large to on-lend to micro and small businesses.
- New loan methodologies and best practices in the field have been introduced to improve the cost-effectiveness of the financial services and returns of the microfinance institutions so that intermediaries may become financially viable organizations with significant impact throughout the country.
- The institutional development capacities of the organization have been

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strengthened and professional financial staff have been hired in most of the supported institutions.

- The Mission is engaged in a continuous policy dialogue with the GOH and other donor organizations to improve the policies and programs that affect the business climate for the microfinance intermediaries and microenterprises.
- By the end of the project (1998) the microfinance intermediaries will have the capacity to disburse over 105,000 loans per year, serving approximately 54,000 active clients with an outstanding portfolio of L164 million. In addition, a private commercial bank will be in place, offering full financial services to micro and small businesses in Honduras.

**12. SUMMARY OF FINANCIAL RESOURCES UTILIZED BY
 USAID TO SUPPORT MICRO AND SMALL BUSINESS
 DEVELOPMENT IN HONDURAS.**

PROJECT NAME	PROJECT NUMBER	TOTAL AMOUNT	LOCAL CURRENCY	DEVELOP. ASSIST.
Pan American Development Foundation	522-ESF-0263	132,000	0	132,000
Small Scale Enterprise Assistance	522-ESF-0263	1,000,000	1,000,000	0
Federation of Private Development Organizations	522-0266	500,000	0	500,000
Artisan Product Marketing	522-0250	510,000	0	510,000
Small Business Development	522-0205	4,800,000	4,000,000	800,000
Microenter-prise Development Program	522-ESF-0319	325,000	325,000	0

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PROJECT NAME	PROJECT NUMBER	TOTAL AMOUNT	LOCAL CURRENCY	DEVELOP. ASSIST.
Sub-Total Phase I		7,267,000	5,325,000	1,942,000
Small Business II (Sub-Total Phase II)	522-0241	35,025,000	16,000,000	19,025,000
Grand Total		\$42,292,000	\$21,325,000	\$20,967,000

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